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DIRECTORATE OF INTELLIGENCE

21 October 1985

Japan: Avoiding Economic Stimulus? [redacted] 25X1

Summary

The package of measures to expand domestic demand adopted by the Japanese Cabinet last week will have only a slight effect on Japan's economic growth and the trade surplus with the United States. By focusing on increased credit for housing and consumer goods and on incentives to encourage private investment, the package did not appreciably boost or alter public works spending. Tokyo projects a $20 billion increase in GNP and a $2 billion rise in total imports as a result of the package, but we believe the figures are too optimistic. If fully implemented, the new program will probably reduce Tokyo's trade surplus with the United States by $1 billion at most in 1986. [redacted] 25X1

The measures slated by the Cabinet for further study, such as steps to encourage increased private investment without new public outlays, are also unlikely soon to affect Japanese economic growth. Macroeconomic policy actions that could substantially reduce the trade imbalance--for example, by reducing the high rate of savings--and any endorsement of longer term tax reform to channel future growth away from exports and into domestic spending also were conspicuously absent from the Cabinet's new program. [redacted] 25X1

This memorandum was prepared by [redacted] Office of East Asian Analysis. Information as of 21 October 1985 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA [redacted] 25X1 25X1

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Turning Growth Inward

Japan's efforts to ease the trade imbalance have thus far concentrated on measures to open specific markets and to end practices labeled unfair by its trading partners. Tokyo, however, has done little to address arguments that Japan's economic structure and its current macroeconomic policy are major causes of its massive surpluses. [redacted] 25X1

The arguments, from European as well as US critics, claim that without a new macroeconomic approach:

-- The high savings rate, averaging about 18 percent of after-tax income compared with about 6 percent for the United States, will continue to discourage consumption and hold down economic growth.

-- Domestic investment and government spending will remain too small to absorb the savings; its consequent outflow to attractive, high-yielding investments in the United States will inevitably weaken the yen, in turn encouraging exports and discouraging imports.

-- Tokyo's tight budgets and deficit-reduction program will ensure that economic growth remains slow. [redacted] 25X1

The Japanese Cabinet's Modest Proposals

We believe the intense scrambling by government and ruling party officials over the past month to approve an economic stimulus program was intended largely to convince Washington that Tokyo was doing its best to ease the trade imbalance before Prime Minister Nakasone meets with President Reagan this week. From the start, the Japanese Government's longstanding commitment to reducing the budget deficit without any increase in taxes eliminated the option of large increases in government spending. The measures adopted by the Cabinet include:

-- Increasing central and local government spending on public works by about $8 billion.

-- Establishing a special loan system for housing.

-- Making about 30 pieces of government land totaling about 200 hectares available for private construction.

-- Encouraging electric and gas utilities to increase investment.

-- Providing an unspecified amount to fund loans through the Japan Development Bank for plant and equipment investment.

-- Increasing the availability of consumer credit. [redacted] 25X1

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Tokyo's unwillingness to abandon fiscal austerity was even more obvious in the longer term measures approved for further study: private-sector construction of public works, easing of regulations restricting business activity, extension of the five-day workweek, and release of additional government-owned land. These measures, which aim to expand business activity at little or no cost to the government, are, in our view, primarily wishful thinking. [redacted] 25X1

Impact on the Trade Balance

We believe that the projections of Japan's Economic Planning Agency (EPA), which claims the new program will increase public- and private-sector investment by about $14 billion over the next 12 months, raise GNP by nearly $20 billion, and boost imports by about $2 billion, are considerably overstated. Almost half of the $14 billion increase in investment expected by the EPA is intended to come from businesses and consumers who--the government hopes--will take advantage of improved incentives to spend. In our view, the new incentives are simply not substantial enough to generate the EPA's projected level of investment. By the same token, the program's approach to new government spending is also less than meets the eye. Much of the increased expenditure on public works only moves funds from fiscal year 1986 to the fiscal year 1985 budget and does not represent an overall rise in spending commitments. [redacted] 25X1

Our analysis indicates that the new program will increase total investment by less than $10 billion next year, and boost GNP by $15 billion and imports by about $1.5 billion. Japanese imports from the United States would probably total about half of this increase or less than $1 billion, at a time when the US trade deficit with Japan is fast approaching $50 billion. [redacted] 25X1

Looking Further Ahead

The Cabinet's demand expansion package does not include--even as items for further study--measures that would directly decrease the incentive to save. It also lacks proposals to reform the tax system. Without such reforms, in our view, there will probably be little to encourage new investment in, or orientation toward, production for the domestic economy rather than for export. Small housing and investment tax credits and a small cut in personal income tax rates will probably be adopted in next year's budget. They were not mentioned in the new program--but we expect them to have a slight impact at best on domestic economic activity. The larger, and politically controversial, question of tax reform--which we believe could have a major impact on the trade balance over several years--will probably be put off until 1987-88 at the earliest, however. [redacted] 25X1

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The Japanese proponents of economic stimulus--such as LDP Executive Council Chairman Miyazawa--are for now unable to make much headway against the government and party consensus in favor of fiscal austerity. In our view, Tokyo agreed to adopt its limited program to expand domestic demand only after sustained pressure from the United States and the European Community to ease the trade imbalance. We cannot rule out, however, increased attention to domestic demand in the next few years if this pressure increases or if Tokyo becomes convinced that its economic vitality is threatened by the uncertainty of its export markets. [redacted] 25X1

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Table 1

Japan: Macroeconomic Policy Options*

Option	Objective	Proponents	Opponents	Comment
Short-Term Measures				
1. Housing incentives: - Give tax breaks and improve access to credit - Ease zoning laws - Release public land for private uses	Reduce savings rate; increase consumer spending for appliances, furniture	Prime Minister Nakasone Economic Planning Agency EPA Labor unions	Finance Ministry	Some combination of tax incentives and increased credit availability likely to pass Diet this fall. Making mortgage interest tax deductible unlikely in next few years.
2. Cut income taxes - Reduce personal tax rates	Stimulate consumer spending and imports	Prime Minister Nakasone Labor unions Opposition parties	Finance Ministry Keidanren	Small cuts in personal tax rates possible in fiscal 1986 or 1987. Large cuts unlikely unless revenue losses made up from other sources.
- Reduce corporate tax rates	Stimulate domestic investment and reduce savings	Keidanren MITI	Finance Ministry	Influential businessmen argue that Japan's high corporate tax rates are depressing domestic investment, growth, and imports. More investment in plant and equipment, however, may increase Japanese companies' export prowess.
3. Expand government spending - Social insurance programs - Public works - Defense - Parks, environment	Increase domestic use of excess savings to reorient growth away from exports and to domestic sources	LDP Executive Council Chairman Miyazawa Opposition parties Ministry of Construction	Prime Minister Nakasone Keidanren Finance Ministry	Small moves in this direction likely over next year. Major expansion of government spending unlikely as long as government and party consensus in favor of reducing budget deficits remains strong.

*For expository purposes, we have regrouped the options Tokyo outlined this summer and have added some of our own. Short-term measures are those designed to boost economic growth within 18 months.

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Option	Objective	Proponents	Opponents	Comment
4. Ease monetary policy	Lower real interest rates and improve credit availability to encourage domestic investment and consumer spending	LDP Vice President Nikaido LDP Executive Council Chairman Miyazawa EPA	Finance Ministry Bank of Japan	Bank of Japan fears lower Japanese interest rates would accelerate capital outflow, putting downward pressure on the yen and worsening the trade imbalance. The Cabinet, however, approved easier credit terms for housing and consumer finance last week.
Long-Term Measures				
5. Reform the tax code	Major revamping of the tax code to encourage domestic investment and consumption, discourage savings	Prime Minister Nakasone Keidanren	LDP leaders Finance Ministry	Under study by special government and party committees. The Finance Ministry insists tax reform be revenue neutral, which would require tax cuts be balanced by new revenue sources such as the introduction of new indirect taxes or a value-added tax. Increased debate over tax reform expected to begin next year but is unlikely to yield final decision before fiscal 1988 at earliest.
6. Reduce or eliminate tax exemption on personal savings	Reduce Japan's high savings rate, slow capital outflow, and strengthen yen. Also, encourage consumer spending and imports.	Prime Minister Nakasone Finance Ministry EPA	Influential LDP politicians Ministry of Post and Telecommunications	This political hot potato surfaced last year, to be quickly shot down by LDP members. Implementation highly unlikely in next year or two.
7. Deregulate industry: - Remove restrictions on private firms; ease zoning restrictions	Boost domestic investment, make more land available for housing.	Prime Minister Nakasone Finance Ministry MITI Keidanren	Transportation Ministry Construction Ministry	Key to Nakasone's vaunted administrative reform effort designed to improve the efficiency of the central government. Some steps may be taken by Diet this fall. Deregulation moves could improve export competitiveness.

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Option	Objective	Proponents	Opponents	Comment
8. Encourage "private-sector vitality"	Stimulate economic growth, boost imports, absorb domestic savings by encouraging private-sector spending	Prime Minister Nakasone Keidanren MITI Construction Ministry		A catch phrase for Tokyo's as yet unclear efforts to convince the private sector to finance and construct projects such as the long-planned Tokyo Bay bridge. It appears the government is willing to make it easier for firms that aid in the financing to acquire construction contracts.
9. Promote a five-day workweek	Allow more leisure time and thus encourage spending on consumer goods	Labor unions Opposition parties Prime Minister Nakasone LDP Executive Council Chairman Miyazawa	Business organizations	Some major companies have five-day workweeks now, but many employees do not take all leave they are entitled to. Government may require banks to close an additional Saturday a month--they are now closed one--to discourage saving. Included for further study in Tokyo's current demand expansion package.

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